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IN THE

Supreme Court of the United States

October Term, 1968

No. 849

ROBERT I. INGALLS, JR. and MRS. JANE S. INGALLS,
Petitioners,

versus

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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To The Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States of America:

Petitioners pray that a writ of certiorari be issued to the United States Court of Appeals for the Fifth Circuit to review that Court's decision reversing the judgment in favor of Petitioners rendered in the United States District Court for the Northern District of Alabama, Southern Division.

OPINIONS BELOW

The opinion of the District Court is reported at 272

F.Supp. 10 and is reproduced as Appendix A to this petition. The opinion of the Court of Appeals for the Fifth Circuit is reported at 399 F.2d 143, and is reproduced as Appendix B to this petition. Petitioners' application for rehearing was denied by the Court of Appeals without opinion on September 26, 1968.

JURISDICTION

This Court has jurisdiction under 28 U.S.C., Section 1254. The judgment of the Court of Appeals was entered on August 9, 1968 and rehearing was denied on September 26, 1968.

QUESTION PRESENTED

For income tax purposes, should the Courts disregard a contract between Robert Ingalls and Ingalls Iron Works Company which provided for the Company to purchase his employment contract by paying him ten equal annual installments of Twenty-Two Thousand Eight Hundred Thirty-Six ($22,836) Dollars each; solely because at the same time he agreed to pay his indebtedness to the Company in equal amounts on the same dates?

STATUTES INVOLVED

This petition involves the year in which income is taxable. Section 451 of the Internal Revenue Code of 1954; 26 U.S.C. 1964 Ed. Section 451:

"The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period."

Also involved is Section 61 of the Internal Revenue Code of 1954; 26 U.S.C. 1964 Ed. Section 61(12):

"Section 61. Gross Income Defined.
(a) Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

* * * *

"(12) Income from discharge of indebtedness;
. . ."

STATEMENT OF THE CASE

This case was tried to the District Judge without a jury. Petitioners cannot state the case more accurately than by copying the statement of the case made by the trial court, appearing on pages 29 through 39 of Appendix A hereto, which is as follows (references to the record added by Petitioners):

I
STATEMENT OF THE CASE

"This is a suit for the refund of income tax paid by the Plaintiffs for the year 1961. Their return was timely filed and the tax shown to be due thereon was paid. Upon examination of the return a deficiency in income tax in the amount of $150,784.74 was assessed and paid together with interest thereon in the amount of $30,174.61. Plaintiffs filed a timely claim for refund for tax and interest in the amount of $180,959.35. The claim was disallowed and Plaintiffs filed this suit for refund of the amount paid within the time allowed by law. The case was heard by the court without a jury and was submitted upon oral testimony and documentary evidence. Counsel for the parties filed excellent briefs.

II
THE FACTS

"Plaintiff, Robert I. Ingalls, Jr., (hereinafter referred to as Ingalls) entered into a written contract of employment with Ingalls Iron Works Company, Inc. (hereinafter referred to as the Company) on the 19th day of March, 1959, the terms of which were that the Company agreed to pay him $100,000 per year for a term of fifteen years to serve as its general manager during that period (Pl. Ex 6; R. 31, 126-131). This contract was approved and ratified by the Company's directors. Such a contract had precedent in that a similar contract had been entered into by the Company and Robert I. Ingalls, Sr. prior to his death and during the time

that he served as general manager and president of the Company (Pl. Ex. 16).

"The stock of the Company was owned by Plaintiff, his mother and two banks as Trustees for Plaintiff's two daughters (R. 31). For more than ten years prior to January 30, 1961, the Ingalls family had been engaged in bitter and prolonged legal warfare over the control of Ingalls Iron Works Company and its subsidiaries (R. 31, 67-68). The undisputed testimony was that the thrust of the litigation was by the members of Plaintiff's family (and/or their Trustees) to force his removal as officer, director, employee and trustee, and to also force him to dispose of his stock in the Company. Negotiations were continuous and bitter in and out of the courts by teams of lawyers representing all parties (R. 67-68).

"As of January 30, 1961, Plaintiff was indebted to the Company in the amount of $228,360.00 which indebtedness was evidenced by Plaintiff's promissory note dated September 24, 1958, in the original amount of $258,654.00. This indebtedness was not due on January 30, 1961. The indebtedness was secured by substantial collateral and bore interest at 2% per annum. The evidence is undisputed that this indebtedness had existed for a long period of time prior to the date of the note. Payments had been made from time to time, interest had been paid, new notes had been executed to renew old notes. The indebtedness was bona fide between Plaintiff and his Company and was in negotiable form. The evidence is clear that during the negotiations which resulted in the purchase by the Company of Plaintiff's employ-

ment contract and the renewal of his note to the Company, that Plaintiff admitted his indebtedness to the Company in the face amount of the note and that the Company (or the attorneys representing the other stockholders of the Company) contended that his indebtedness was in excess of the face amount of his note. The evidence is also undisputed that the amount of the indebtedness and the termination of Plaintiff's employment were, in the words of the witness Murray, 'a small part of a large package . . . The large package could not be settled unless all of the pieces were settled and this was a small but critical issue that had to be determined.' (R. 79)

"On January 30, 1961, the legal battles which have often been referred to by this Court and other Courts as 'The Ingalls Litigation' came to an end by an 'overall settlement' negotiated over a period of a year or more. The results, insofar as this case is concerned, can be stated fairly briefly. First, Ingalls entered into a written contract with the Company whereby the 'Company agrees and does purchase from Ingalls, and Ingalls agrees to and does sell to the Company, said contract' (the employment contract dated 19th March, 1959) . . .' and all of Ingalls' rights, interest in and title thereto to the end that said contract is forthwith terminated and extinguished.' (Pl. Ex. 8) The purchase price was $228,360.00 plus interest at 2% after maturity, payable in ten equal annual installments of $22,836.00 each, the first installment being due and payable on February 1, 1962, and a like installment on the same date each year thereafter until paid in full (R. 21-23, 32-33). Second, Ingalls executed a new re-

newal note to the Company dated January 30, 1961, in the amount of $228,360.00 payable in ten equal annual installments of $22,836.00 each, the first installment due February 1, 1962 (Pl. Ex. 4; R. 33, 122). The written agreement between the parties provided, 'that so long as any part of said indebtedness or any interest thereon remains unpaid the Company may make the payments herein agreed to be paid by him by currently crediting said indebtedness with such payments as they accrue.' (R. 23) Third, Ingalls sold all of his stock in the Company to one Hulsey for $3,750,000.00 and thereupon Ingalls resigned as an officer, director, employee and trustee. Fourth, 'The Ingalls Litigation' (pending and threatened in the future) was finally ended.

"On February 1, 1962, and each year thereafter, Plaintiff received from the Company its check in payment of its installment payment on the employment contract. Receipt of such payment was shown each year on Plaintiff's income tax return for the year of receipt and tax was paid thereon. Also, on February 1, 1962, and each year thereafter Plaintiff issued his check to the Company in payment of his installment note and due credit therefor was entered on the note (R. 75).

"Upon examination of Plaintiff's return the Commissioner determined that cancellation of Plaintiff's indebtedness due the Company in return for cancellation of the employment contract resulted in income to Plaintiff of $228,360.00 as of January 30, 1961. Counsel for the Commissioner argues in his brief that 'there

transaction cast in terms insisted upon by the taxpayer. The terms ultimately agreed to were for the benefit of the taypayer to further his attempt to frustrate the taxability in one year of the entire indebtedness cancelled.'

III
THE ISSUE

"There is only one issue to be determined. Did the purchase by Ingalls Iron Works Company of the employment contract between it and Plaintiff, Robert I. Ingalls, Jr., result in income to Plaintiff in the amount of $228,360.00 in the year 1961 by reason of Ingalls' indebtedness to the Company in the same amount?

IV
OPINION

"This Court, based upon the documentary evidence submitted and the oral evidence presented by the witnesses is unable to agree with the Commissioner's determination or the argument presented by his counsel. We find as a fact that there was no cancellation of Plaintiff's indebtedness to the Company. His note was renewed on January 30, 1961, by the execution of a new note for the same amount as the old note with different due dates, and the unpaid portion thereof is still outstanding today. The amount of the note was not changed. There was ample business purpose, insofar as the Company was concerned, to agree to the renewal and the new due dates.

"From the undisputed testimony it is evident that the stockholders who were opposing Plaintiff were convinced that the removal of Plaintiff was essential to the Company's existence. It would be difficult for this Court to conceive of a more pressing business purpose. By purchasing Plaintiff's employment contract on his terms and renewing his note, the Company was most certainly serving its best business purpose.

"Neither party to the negotiations was in a position to dictate all of the terms of the employment contract purchase. The fact that the Plaintiff may have had a personal tax benefit in mind when he insisted on a ten-year payment does not recast the transaction so long as all of the obligations to be fulfilled were contracted for before a right to receive the consideration was definitely fixed and determined. The U. S. District Court for the Eastern District of Arkansas in the case of Oliver v. U.S. (193 Fed. Sup. 930) said:

> '. . . it must be recognized that a taxpayer has a perfect legal right to stipulate that he is not to be paid until some subsequent year, or that the payments are to be spread out over a number of years. Where such a stipulation is entered into between buyer and seller prior to the time when the seller has acquired an absolute and unconditional right to receive payment and where the stipulation amounts to a binding contract between the parties so that the buyer has a legal right to refuse payment except in accordance with the terms of the agreement, then the doctrine of constructive receipt does

not apply and the taxpayer is not required to report the income until the same actually is received by him.'

"The Fifth Circuit Court of Appeals in Williams v. U.S. (219 Fed. 2d 523) said:

> "We . . .'have often declared, as other Courts have, that the taxpayers may conduct their businesses so as to minimize their taxes, provided only that the arrangements are real, not sham arrangements, and are legally effective to accomplish the desired results and that in determining whether the means used are, or are not, effective, the fact that a tax reduction is a moving cause in the choice is not a material factor.'

"The Supreme Court has recognized in Gregory vs. Helvering, 293 U. S. 465, 55 S.Ct. 266, that:

> 'The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.'

"Defendant's argument that Plaintiff's insistence that he be paid on the installment basis for his employment contract and, therefore, cannot recover is not sound under the facts and controlling rules and decisions.

"On January 30, 1961, the date of the over-all settlement, there was no sum past due or due Ingalls by the Company under the employment contract. At that time Ingalls had the absolute right to refuse prepayment of all or any of the semi-monthly installments falling due under the employment contract during the next 12 years. Ingalls had the absolute right to insist upon the semi-monthly payments being made during this 12-year period in accordance with the clear terms of the employment contract. And the Company had no right to force Ingalls to accept any payments before the same became due under the terms of the employment contract.

"What is material is whether or not the creation of the indebtedness of the Company to the Plaintiff by the terms of the employment contract purchase agreement automatically and without the consent, intention or agreement of the parties cancelled plaintiff's debt to the Company. If it did, the Defendant would be entitled to prevail. We find no evidence that the parties to the agreement intended or agreed such to be the case. On the contrary, all of the evidence is that the parties did not so intend. Any cancellation, therefore would have had to have been by operation of law. Even if we could read into this transaction an agreement to cancel the two debts as and when each installment came due, there would be no taxable income accruing to Plaintiff in 1961 because the Courts have consistently held that an agreement to cancel a debt in the future does not create taxable income at the time the agree-

ment is made. Walker vs. Commissioner, 88 Fed. 2d 170 (CCA 5th, 1937), Cert. denied, 302 U.S. 692.

"Defendant argues that the mutual indebtedness of the parties, being in like amounts and having the same due dates effects a set off. A review of the Alabama decisions refutes this contention. Simmons vs. Williams, 27 Ala. 507, Tate vs. Evans, 54 Ala. 16, McDade vs. Mead, 18 Ala. 214, Dudley vs. Whatley, 10 So.2d 43, Slaughter vs. Martin, 63 So. 689, George vs. Cahawba and M. R. Co., 8 Ala. 234. This Court recognizes that it is not necessarily bound by the Alabama decisions, but it is comforting to note that the Fifth Circuit has followed this Alabama law in income tax cases. In the case of Bailey vs. Commissioner of Internal Revenue, 103 Fed. 2d 448, that Court said that:

> 'Mutual debts do not per se extinguish each other.'

"In the same opinion, the Court commented and held that:

> 'A payment does not occur unless the money passes from the debtor to the creditor for the purpose of extinguishing the debt, and the creditor must receive it for the same purpose.'

"At any time subsequent to January 30, 1961, Plaintiff could have discounted or otherwise negotiated the agreement of purchase of his contract. He also could have prepaid his note to the Company and retained and enforced his right to be paid according to the terms of

the contract purchase. By the same reasoning, the Company could have negotiated Plaintiff's note to an innocent purchaser for value at any time that it was not in default. When such is the case, there has been no cancellation of the indebtedness. Without cancellation of the indebtedness in 1961 there can be no omitted income from this source.

"Furthermore, other principals of law applicable to the case at bar are also conclusive on the right of Plaintiffs to recover: (1) the compromise and settlement of claims in dispute does not give rise to taxable income. Mertens Law of Fed. Income Taxation, Vol. 2, Section 11.19 p. 71. (2) There is no income unless and until there has been a release of liability. Mertens Law of Fed. Income Taxation. Vol. 2, Section 11.19 p. 71. (3) When a taxpayer is not enriched taxable income does not result. Mertens Law of Federal Income Taxation Vol. 2, Section 11.19. (4) An agreement to cancel a debt in the future is not income until the debt is actually cancelled. Mertens Law of Fed. Income Taxation, Vol. 2, Section 11.19 Footnote 15.

"This Court is clearly of the opinion that the Plaintiffs did not in fact or constructively receive additional taxable income in 1961 as claimed by the Defendant and that the issue presented should be decided in favor of the Plaintiffs."

REASONS FOR GRANTING THE WRIT

A. Conflict with other circuits.

As long ago as 1945, the Court of Appeals for the

Second Circuit in the case of *Richards Estate v. Commissioner,* 150 F.2d 837, decided substantially the same question as that here involved, in a manner diametrically opposite to the conclusion of the Court below in this case. In that case Mrs. Richards as Executrix obtained a judgment from which the defendants took an appeal, during the pendency of which settlement negotiations were conducted; and in 1937 she accepted a settlement offer made in 1936. The Court said at page 839 (reversing the Tax Court):

> ". . . the first issue is whether the payment made by Presley in 1937 was constructively received by the executrix in 1936 and taxable as income in that year. It is conceded that the full amount of the settlement was taxable income in one year or the other.
>
> "The Tax Court found that 'the proceeds of the settlement in the total sum of $195,000 were available to the Estate of Eugene Lamb Richards in December 1936' and held that the entire amount was taxable as income of the estate in that year. The reasoning of the court which led to this holding was that Mr. Spence, the plaintiff's attorney, could have received the full amount in 1936 had he been willing to do so; that it was constructively received for purposes of taxation in the year during which, but for his desire to make a tax saving, it might have been received.

> "Decision must turn not upon what Mr. Spence might have done in 1936 to accept Presley's offer but upon what, if anything, he did do to make the proceeds of the offer available to the petitioner in that year for her full control and disposition."

And further at the same page:

> "It is equally clear that he was under no obligation to agree to forego any of his client's rights under the judgment except upon such terms as he saw fit to impose, and it is immaterial that his reason for imposing the terms he did was a desire to save taxes. The obligations of the parties under the settlement as agreed to are what count and under them nothing was credited or set apart to the petitioner which could be drawn upon in 1936. At least that much was required by the applicable regulation to constitute constructive receipt of the money Presley agreed to pay. T.R. 111, Section 29.42-2. The money had to be placed unconditionally at the disposal of the petitioner before it was constructively received by her. Lucas v. North Texas Lumber Co., 281 U.S. 11, 50 S.Ct. 184, 74 L.Ed. 668. Compare, Bedell v. Commissioner of Internal Revenue, 2 Cir., 30 F.2d 622, 624. That was not done in 1936."

The factual situation above described is strikingly similar to the settlement in the instant case between Ingalls and the Iron Company. Ingalls could have ac-

cepted the entire $228,000 in 1961, but for tax reasons he did not do so, any more than did Mrs. Richards in 1936. The money was not unconditionally at his disposal in 1961 and therefore it was not constructively received by him then.

In the case of *Oliver G. Willits,* 50 T.C. No. 59, the taxpayer was a trustee, and as such he became entitled to commissions in 1962. But the trustee chose to accept the commissions, one-fourth each in 1962, 1963, 1964 and 1965, and this method of payment was approved by a judgment signed by the Probate Court. The Internal Revenue Service contended that all of the fee was available to the trustee in 1962 and should be taxed to him then under the doctrine of constructive receipt. The Tax Court disagreed, saying that the decree of the Probate Court directing the method of payment was just as effective as though the trustee had entered into a contract with the trust for the payment of his fee over this period of four years; and that if Willits had entered into such a contract, he would have been justified as a cash-basis taxpayer in reporting commissions only in the years of actual receipt, citing *Commissioner v. Oates,* 207 F.2d 711 (C.A. 7, 1953). This is exactly what Ingalls did in the instant case — he entered into a contract for the payment of his salary over a period of ten years.

In the *Oates* case, the taxpayer was an insurance salesman who was entitled to receive commissions on renewals over a nine-year period, in declining amounts each year. He entered into a contract with the company to receive his renewal commissions at the rate of

$1,000 per month. The Commissioner contended that renewal commissions which admittedly accrued to his credit in the amount of $47,000 for 1944 and even larger amounts for 1945 and 1946, were taxable to him under the doctrine of constructive receipt despite his contract to receive only $1,000 per month. The Tax Court held for the taxpayer and the Court of Appeals for the Seventh Circuit affirmed, saying that because of the contract, the taxpayer had no right to demand or to receive anything in excess of $1,000 per month. The court said at page 713 of 207 F.2d:

> "Consequently the rights of the parties are to be determined entirely by the new contract. Under its terms the taxpayer was to receive commissions at the periods and in the fixed amounts stipulated. He was on a cash basis. He had no right to demand or to receive anything in addition to what he had agreed to accept, namely, $1,000 per month."

Had the taxpayer in *Oates* not entered into a new contract, undoubtedly he would have been taxable on the commissions as they accrued. But he did enter into a new contract and, therefore, he is not so taxable. The same principle is equally applicable to Ingalls. There is no justification in the record in the instant case for disregarding the contract between Ingalls and the Company, and therefore the decision of the Fifth Circuit in this case is directly in conflict with that of the Seventh Circuit above quoted.

In *Commissioner v. Olmstead Incorporated Life Agency,* 304 F.2d 16 (C.A. 8, 1962), the Court of Appeals for the Eighth Circuit quoted and approved the decision of the Court of Appeals for the Seventh Circuit in *Oates,* and held that the *Oates* principle applied to the facts in the *Olmstead* case. Here again an insurance agent was entitled to large commissions, but by contract chose to accept smaller amounts payable over a longer period of time. In *Olmstead* the Service took the position that on the theory of constructive receipt the taxpayer was taxable on the entire fair market value ($68,000) of the annuity contract which he made with the insurance company in the year in which he received it, rather than being taxable on $500 per month for fifteen years, in accordance with the terms of the annuity contract. The Court of Appeals held that the parties were bound by the terms of the contract and, therefore, the cash-basis taxpayer was only taxable each year on the amounts to which he was entitled for that year by the terms of the contract.

In *Kasper v. Banek,* 214 F.2d 125 (C.A. 8, 1954) the taxpayer sold grain in October of 1947 under an oral contract that it was not to be paid for until 1948. The Internal Revenue Service contended that the proceeds of the sale were available to the taxpayer in 1947 and were therefore taxable to him in that year. The District Court directed a verdict in favor of the taxpayer. The Court of Appeals held that it was a question for the jury whether the proceeds of the sale were not payable until 1948, and that if this was in fact the contract between the parties, then the courts could not disregard it.

In *Glenn v. Penn,* 250 F.2d 507 (C.A. 6, 1958) the taxpayer sold tobacco under an oral agreement similar to that in *Kasper,* supra. The District Court directed a verdict for the taxpayer but the Court of Appeals for the Sixth Circuit reversed, saying at page 508:

> "On the other hand, if the contract between the parties under which the tobacco was sold at auction provided that payment of the net proceeds was not to be made to the taxpayers until after March 1 and taxpayers had no legal right to require its payment before that time, there was no constructive receipt of the money prior to that time and the taxpayers were correct in not including it as income for the taxable years in question."

The Court of Appeals held that the question should have been submitted to the jury because the contract was oral, but made it entirely plain that if there had been a written enforceable contract, the Courts could not disregard it.

Petitioners submit that the decision in the instant case is directly in conflict with those of the Court of Appeals for the Second Circuit in *Richards;* the Sixth Circuit in *Glenn;* the Seventh Circuit in *Oates;* the Eighth Circuit in *Olmstead* and *Kasper,* and the Tax Court in *Willits;* all above quoted.

The principle of these cases has been widely followed. Mertens Law of Federal Income Taxation Section 11.19 says beginning at page 85:

> "Furthermore, there is no income unless and until there has been a release of liability."

In support of this statement Mertens cites many cases from almost all of the circuits, including two from the Fifth Circuit. In the present case petitioner was not released from any liability on his indebtedness to the Iron Company in 1961, and for that reason petitioners say that the above quotation from Mertens is squarely applicable to the facts in the present case.

B. Conflict with decision of this Court.

Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266 is well known for the statement:

> "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, can not be doubted."

To paraphrase, the right of Ingalls to accept payment in ten equal annual installments rather than in a lump sum, in order to decrease his taxes, cannot be doubted.

Lucas v. North Texas Lumber Company, 281 U.S. 11, 50 S.Ct. 184, 74 L.Ed. 668, held that gain from a transaction did not become taxable income in 1916 when the Buyer offered to close and pay the purchase price, but in 1917 when the title actually passed and the Seller received the money. This principle requires a holding that Petitioners' trade with the Iron Company

did not create taxable income in 1961, but only as the payments were made to him in later years by the terms of the contract.

C. Conflict with other decisions of the Fifth Circuit.

In the case of *Barran v. Commissioner,* 334 F.2d 58 (C.A. 5, 1964) the parties had contracted for the payment of one sum in consideration for an agreement not to compete, and for a different sum in consideration for the conveyance of stock of the corporation. The taxpayers contended that the amounts which they received under the contract not to compete should have been treated as capital gain derived from the sale of good will. The Tax Court disagreed and the Fifth Circuit affirmed, emphasizing the importance of the contract reached by arm's length negotiations, and saying at page 62 that in the cases relied on by the taxpayer: "There was no separate consideration for the agreement not to compete." And further on the same page:

> ". . . in neither of these cases did the parties make an effort to allocate portions between the selling price of the assets and consideration for the undertaking not to compete."

And further at pages 63-64:

> "On the issue of the character of the covenants, it is important that the parties themselves in their agreements placed a separate value on the covenants not to compete. These covenants were the subject of much negotiations and

discussion. The partners sought unsuccessfully to have Pet post security, and their attorney testified that he hassled a good while with Pet before reaching an understanding that in the event of the death of either partner, any remaining payments would be made to the partner's estate. It has been said that when parties to this type of transaction specifically contract for the covenants and give them an assigned value, strong proof must be adduced to overcome the declaration. Ullman v. Commissioner, supra, 264 F.2d 308, approving Hamlin's Trust v. Commissioner, supra 209 F.2d at 765. Rogers v. United States, 290 F.2d 501 (9th Cir. 1961), held that it was proper for the trial court to refuse to look beyond the agreement in which the parties set out a specific amount for a restrictive covenant and to treat the amount as ordinary income."[2]

"[2]. The Courts that have contributed to the jurisprudence in this field seem to hold that where the parties bargain at arm's length over the terminology to be used in expressing an agreement not to compete and conclude with a specific agreement including a separately stated consideration not to compete, this amounts to something like a bargain between them that the seller, covenator, will assume the unfavorable tax consequences flowing from the receipt of the consideration and the purchaser will get the corresponding tax benefits. See Yandell v. United States, 208 F.Supp. 306,

> Aff'd (9th Cir. 1962) 315 F.2d 141. We need not go so far in order to agree that there is a heavy burden on the taxpayer in such a situation. Cf. Nelson Weaver Realty Co. v. CIR, (5th Cir. 1962) 307 F.2d 897, 904."

The above quotation is squarely applicable to the facts in the instant case. Here Ingalls bargained at arm's length with the Iron Company as to the time when his salary was to be payable; the parties arrived at a decision; and incorporated it into a contract. This contract should not be disregarded any more than was the contract in the *Barran* case.

The principle of the *Barran* case was followed in *Balthrope v. Commissioner,* 356 F.2d 28, (C.A. 5, 1966). In that case the taxpayer sold his radio station by a contract which allocated a specific part of the purchase price to payments not to compete. The court said at page 31:

> "When a vendor covenants not to compete, conflicting tax interests of vendor and vendee usually influence the amount of the purchase price allocated to the covenant. The vendor prefers a low price for his covenant, taxable as ordinary income, and a high price for capital assets such as stock and goodwill, taxable at lower capital gains rates. The vendee prefers a high basis for the covenant with accompanying depreciation deductions and a low allocation to stock and goodwill, which are non-depreciable. See Note, Tax Treatment of Coven-

> ants Not To Compete: A Problem of Purchase Price Allocation, 67 Yale L.J. 1261, 1263 (1958); Barnet, Covenants Not To Compete, N.Y.U. 18th Inst. on Fed. Tax 861, 864-65 (1960).
>
> "Courts generally honor the parties' bargaining for tax consequences dependent upon the price of a vendor's covenant not to compete."

Immediately following the quotation above set out, the opinion added that courts need not honor the vendor's covenant which has no basis in economic reality; but no one has ever contended that the contract in the instant case is lacking in economic reality. Accordingly, Petitioners say that the above quotation also is squarely applicable to the facts in the instant case, and the Courts should honor the parties' bargaining in the present case just as in *Balthrope*.

In the present case the parties bargained for the tax consequences of the transaction. The Iron Company preferred for the entire salary payment to have been deductible by it in 1961, but Petitioners would not agree to accept it in 1961. As a result of the bargaining, the Iron Company lost the tax benefit it would have liked, but the present decision of the Fifth Circuit denies to Petitioners the benefit from the bargain; and in effect gives the Government the benefit as against both of the parties to the contract, thereby expressly dishonoring the parties' bargaining for tax consequences, contrary to the above quotation.

In the case of *Blackstone Realty Co. v. Commissioner,* 398 F.2d 991 (C.A. 5, 1968) affirming T.C. Memo 1966-156, the question was the allocation of the total selling price among the various properties transferred. The Court affirmed the Tax Court on the reasoning that while the contract specified the total price, it did not specify any allocation, and the claimed arm's length allocation of $100,000 to the improvements was not, in fact, supported by the testimony in the record. This case again affirms the principle of *Barran* and *Balthrope,* which is that when taxpayers negotiate at arm's length and reach an agreement, the Courts give effect to that agreement. The same principle should be applied to the agreement in the instant case.

Practically all of the circuits have agreed with the principle of accepting the parties' arm's length allocation in covenants not to compete. For example, see *Hamlin's Trust v. Commissioner,* 209 F.2d 761 (C.A. 10, 1954), *Ullman v. Commissioner,* 264 F.2d 305 (C.A. 2, 1959) and *Commissioner v. Danielson,* 378 F.2d 771 (C.A. 3, 1967). Exactly the same principle of arm's length negotiations applies to the contract involved in this case. The agreement so reached by the parties should not be disregarded by the Courts.

As a matter of abstract logic, it is impossible to justify the proposition, apparently inherent in the decision in the instant case, that constructive receipt requires the taxation of income to a taxpayer whenever it may be said that income is available to him. For example, a taxpayer who purchases one hundred shares of U. S. Steel stock on the New York Stock Exchange

and sees it enhance in price, has it within his power to sell the stock at the end of five months. If he elects to hold it seven months rather than five, thereby achieving long-term capital gain rather than short-term gain which is taxable as ordinary income, it cannot be said that he had the power to sell the stock at the end of five months and, therefore, it is then taxable to him; even though he did not in fact sell it until the end of seven months. The same principle is applicable to the instant case. It was within the power of Ingalls to negotiate to cancel his employment contract in 1961; but he did not in fact do so. On the contrary, he contracted for the payment of a salary to him each year for ten years. Logically, this is exactly the same as the investor electing to hold his U. S. Steel stock for seven months rather than for five months. Petitioners respectfully submit that the decision in this case is a dangerous and unwarranted extension of the doctrine *of constructive receipt.*

D. This is an issue of importance in the administration of the income tax laws of the United States.

Upon examination of Petitioner's 1961 income tax return the Commissioner determined that contrary to the express terms of the contract itself, the contract somehow constituted a concellation of his indebtedness due to the Company in return for the cancellation of his employment contract, resulting in taxable income to Petitioners of $228,360.00 on January 30, 1961. Petitioners say that they owe the income tax only on $22,836

for 1961, and on the remainder as they receive it during the next nine years.

This question of *when* receipts are taxable is fundamental to the administration of our tax laws. It recurs frequently, and affects innumerable individuals and business transactions. A decision of the instant case by this Court will establish guide lines in the area of constructive receipt, which are badly needed and which will resolve the doubts indicated by the large number of cases in which the Commissioner of Internal Revenue has attempted to force his concept of constructive receipt upon startled taxpayers. These efforts have been rejected by almost all Courts in this type of case, except by the Court of Appeals for the Fifth Circuit.

CONCLUSION

Robert Ingalls' salary, payable under the terms of the contract in ten equal annual installments, should no more be taxable to him in full in 1961 than was Richards' settlement proceeds taxable in 1936, or was Willits' executor's fee taxable to him in full in 1962, or was Oates' insurance commissions taxable to him in 1944, or was Olmstead's insurance commissions taxable to him in 1956, or was the proceeds of the sale of grain taxable to Banek in 1947, or the proceeds of the sale of tobacco taxable to Penn in 1947, or the proceeds of the sale of land taxable to North Texas Lumber Company in 1916. And the contract between Ingalls and the Iron Company in the present case should no more be disregarded than were the contracts in *Barran, Balthrope, Hamlin, Ullman* and *Danielsen,* all supra.

Petitioners therefore respectfully submit that for the reasons set out in this petition, the writ of certiorari should be granted as prayed herein.

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Counsel for Petitioners

OF COUNSEL:
Bainbridge & Mims
Markstein & Morris

CERTIFICATE OF SERVICE

I hereby certify that service of this petition has been made on opposing counsel by mailing four copies thereof on this ___ day of December 1968 in an envelope with postage prepaid, properly addressed, to the Solicitor General, Department of Justice, Washington, D.C. 20530.

Walter L. Mims

APPENDIX A

IN THE UNITED STATES DISTRICT COURT FOR
THE NORTHERN DISTRICT OF ALABAMA
SOUTHERN DIVISION

ROBERT I. INGALLS, JR., and
MRS. JANE S. INGALLS,
Plaintiffs,
versus Civil Action No. 66-289

UNITED STATES OF AMERICA,
Defendant.

Filed in Clerk's Office, Northern District of Alabama, May 16, 1967. William E. Davis, Clerk, U. S. District Court. By Mary L. Tortorici, Deputy Clerk.

MEMORANDUM OPINION

I
STATEMENT OF THE CASE

This is a suit for the refund of income tax paid by the Plaintiffs for the year 1961. Their return was timely filed and the tax shown to be due thereon was paid. Upon examination of the return a deficiency in income tax in the amount of $150,784.74 was assessed and paid together with interest thereon in the amount of $30,174.61. Plaintiffs filed a timely claim for refund for tax and interest in the amount of $130,959.35. The claim

was disallowed and Plaintiffs filed this suit for refund of the amount paid within the time allowed by law. The case was heard by the court without a jury and was submitted upon oral testimony and documentary evidence. Counsel for the parties filed excellent briefs.

II
THE FACTS

The court finds the facts to be as follows:

Plaintiff, Robert I. Ingalls, Jr., (hereinafter referred to as Ingalls) entered into a written contract of employment with Ingalls Iron Works Company, Inc. (hereinafter referred to as the Company) on the 19th day of March, 1959, the terms of which were that the Company agreed to pay him $100,000.00 per year for a term of fifteen years to serve as its general manager during that period. This contract was approved and ratified by the Company's directors. Such a contract had precedent in that a similar contract had been entered into by the Company and Robert I. Ingalls, Sr. prior to his death and during the time that he served as general manager and president of the Company.

The stock of the Company was owned by Plaintiff, his mother and two banks as Trustees for Plaintiff's two daughters. For more than ten years prior to January 30, 1961, the Ingalls family had been engaged in bitter and prolonged legal warfare over the control of Ingalls Iron Works Company and its subsidiaries. The undisputed testimony was that the thrust of the litigation was by the members of Plaintiff's family (and/or

their Trustees) to force his removal as officer, director, employee and trustee, and to also force him to dispose of his stock in the Company. Negotiations were continuous and bitter in and out of the courts by teams of lawyers representing all parties. It is evident from the undisputed testimony that the success or failure of the Company was at stake.

As of January 30, 1961, Plaintiff was indebted to the Company in the amount of $228,360.00 which indebtedness was evidenced by Plaintiff's promissory note dated September 24, 1958, in the original amount of $258,654.00. This indebtedness was not due on January 30, 1961. The indebtedness was secured by substantial collateral and bore interest at 2% per annum. The evidence is undisputed that this indebtedness had existed for a long period of time prior to the date of the note. Payments had been made from time to time, interest had been paid, new notes had been executed to renew old notes. The indebtedness was bona fide between Plaintiff and his Company and was in negotiable form. The evidence is clear that during the negotiations which resulted in the purchase by the Company of Plaintiff's employment contract and the renewal of his note to the Company, that Plaintiff admitted his indebtedness to the Company in the face amount of the note and that the Company (or the attorneys representing the other stockholders of the Company) contended that his indebtedness was in excess of the face amount of his note. The evidence is also undisputed that the amount of this indebtedness and the termination of Plaintiff's employment were, in the words of the witness Murray, "a small part of a large package. . . .

The large package could not be settled unless all of the pieces were settled and this was a small but critical issue that had to be determined."

On January 30, 1961, the legal battles which have often been referred to by this Court and other Courts as "The Ingalls Litigation" came to an end by an "overall settlement" negotiated over a period of a year or more. The results, insofar as this case is concerned, can be stated fairly briefly. *First* Ingalls entered into a written contract with the Company whereby the "Company agrees and does purchase from Ingalls, and Ingalls agrees to and does sell to the Company, said contract" (the employment contract dated 19th March, 1959) . . ." and all of Ingalls' rights, interest in and title thereto, to the end that said contract is forthwith terminated and extinguished." The purchase price was $228,360.00 plus interest at 2% after maturity, payable in ten equal annual installments of $22,836.00 each, the first installment being due and payable on February 1, 1962, and a like installment on the same date each year thereafter until paid in full. *Second,* Ingalls executed a new renewal note to the Company dated January 30, 1961, in the amount of $228,360.00 payable in ten equal annual installments of $22,836.00 each, the first installment due February 1, 1962. The written agreement between the parties provided, "that so long as any part of said indebtedness or any interest thereon remains unpaid the Company may make the payments herein agreed to be paid by him by currently crediting said indebtedness with such payments as they accrue." *Third,* Ingalls sold all of his stock in the Company to one Hulsey for $3,750,000.00 and thereupon

Ingalls resigned as an officer, director, employee and trustee. *Fourth,* "The Ingalls Litigation" (pending and threatened in the future) was finally ended.

On February 1, 1962, and each year thereafter, Plaintiff received from the Company its check in payment of its installment payment on the employment contract. Receipt of such payment was shown each year on Plaintiff's income tax return for the year of receipt and tax was paid thereon. Also, on February 1, 1962, and each year thereafter Plaintiff issued his check to the Company in payment of his installment note and due credit therefor was entered on the note.

Upon examination of Plaintiff's return the Commissioner determined that cancellation of Plaintiff's indebtedness due the Company in return for cancellation of the employment contract resulted in income to Plaintiff of $228,360.00 as of January 30, 1961. Counsel for the Commissioner argues in his brief that "there were no business reasons for the Company to have the transaction cast in terms insisted upon by the taxpayer. The terms ultimately agreed to were for the benefit of the taxpayer to further his attempt to frustrate the taxability in one year of the entire indebtedness cancelled."

III
THE ISSUE

There is only one issue to be determined. Did the purchase by Ingalls Iron Works Company of the employment contract between it and Plaintiff, Robert I. Ing-

alls, Jr., result in income to Plaintiff in the amount of $228,360.00 in the year 1961 by reason of Ingalls' indebtedness to the Company in the same amount?

IV
OPINION

This Court, based upon the documentary evidence submitted and the oral evidence presented by the witnesses is unable to agree with the Commissioner's determination or the argument presented by his counsel. We find as a fact that there was no cancellation of Plaintiff's indebtedness to the Company. His note was renewed on January 30, 1961, by the execution of a new note for the same amount as the old note with different due dates, and the unpaid portion thereof is still outstanding today. The amount of the note was not changed. There was ample business purpose, insofar as the Company was concerned, to agree to the renewal and the new due dates.

From the undisputed testimony it is evident that the stockholders who were opposing Plaintiff were convinced that the removal of Plaintiff was essential to the Company's existence. It would be difficult for this Court to conceive of a more pressing business purpose. By purchasing Plaintiff's employment contract on his terms and renewing his note, the Company was most certainly serving its best business purpose.

Neither party to the negotiations was in a position to dictate all of the terms of the employment contract purchase. The fact that the Plaintiff may have had a per-

sonal tax benefit in mind when he insisted on a ten-year payment does not recast the transaction so long as all of the obligations to be fulfilled were contracted for before a right to receive the consideration was definitely fixed and determined. The U. S. District Court for the Eastern District of Arkansas in the case of Oliver vs. U. S. (193 Fed. Sup. 930) said:

> ". . . it must be recognized that a taxpayer has a perfect legal right to stipulate that he is not to be paid until some subsequent year, or that the payments are to be spread out over a number of years. Where such a stipulation is entered into between buyer and seller prior to the time when the seller has acquired an absolute and unconditional right to receive payment and where the stipulation amounts to a binding contract between the parties so that the buyer has a legal right to refuse payment except in accordance with the terms of the agreement, then the doctrine of constructive receipt does not apply and the taxpayer is not required to report the income until the same actually is received by him."

The Fifth Circuit Court of Appeals in Williams vs. U. S. (219 Fed. 2d 523) said:

> We . . . "have often declared, as other Courts have, that the taxpayers may conduct their businesses so as to minimize their taxes, provided only that the arrangements are real, not sham arrangements, and are legally effective

> to accomplish the desired results and that, in determining whether the means used are, or are not, effective, the fact that a tax reduction is a moving cause in the choice is not a material factor."

The Supreme Court has recognized in Gregory vs. Helvering, 293 U.S. 465, 55 S. Ct. 266, that:

> "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."

Defendant's argument that Plaintiff's insistence that he be paid on the installment basis for his employment contract and, therefore, cannot recover is not sound under the facts and controlling rules and decisions.

On January 30, 1961, the date of the over-all settlement, there was no sum past due or due Ingalls by the Company under the employment contract. At that time Ingalls had the absolute right to refuse prepayment of all or any of the semi-monthly installments falling due under the employment contract during the next 12 years. Ingalls had the absolute right to insist upon the semi-monthly payments being made during this 12-year period in accordance with the clear terms of the employment contract. And the Company had no right to force Ingalls to accept any payments before the same became due under the terms of the employment contract.

What is material is whether or not the creation of the indebtedness of the Company to the Plaintiff by the terms of the employment contract purchase agreement automatically and without the consent, intention or agreement of the parties cancelled plaintiff's debt to the Company. If it did, the Defendant would be entitled to prevail. We find no evidence that the parties to the agreement intended or agreed such to be the case. On the contrary, all of the evidence is that the parties did not so intend. Any cancellation, therefore would have had to have been by operation of law. Even if we could read into this transaction an agreement to cancel the two debts as and when each installment came due, there would be no taxable income accruing to Plaintiff in 1961 because the Courts have consistently held that an agreement to cancel a debt in the future does not create taxable income at the time the agreement is made. Walker vs. Commissioner, 88 Fed. 2d 170 (CCA 5th, 1937) Cert. denied, 302 U. S. 692.

Defendant argues that the mutual indebtedness of the parties, being in like amounts and having the same due dates effects a set off. A review of the Alabama decisions refutes this contention. Simmons vs. Williams, 27 Ala. 507, Tate vs. Evans, 54 Ala. 16, McDade vs. Mead, 18 Ala. 214, Dudley vs. Whatley, 10 So. 2d 43, Slaughter vs. Martin, 63 So. 689, George vs. Cahawba and M. R. Co., 8 Ala. 234. This Court recognizes that it is not necessarily bound by the Alabama decisions, but it is comforting to note that the Fifth Circuit has followed this Alabama law in income tax cases. In the case of Bailey vs. Commissioner of Internal Revenue, 103 Fed. 2d 448, that Court said that:

> "Mutual debts do not per se extinguish each other."

In the same opinion, the Court commented and held that:

> "A payment does not occur unless the money passes from the debtor to the creditor for the purpose of extinguishing the debt, and the creditor must receive it for the same purpose."

At any time subsequent to January 30, 1961, Plaintiff could have discounted or otherwise negotiated the agreement of purchase of his contract. He also could have prepaid his note to the Company and retained and enforced his right to be paid according to the terms of the contract purchase. By the same reasoning, the Company could have negotiated Plaintiff's note to an innocent purchaser for value at any time that it was not in default. When such is the case, there has been no cancellation of the indebtedness. Without cancellation of the indebtedness in 1961 there can be no omitted income from this source.

Furthermore, other principals of law applicable to the case at bar are also conclusive on the right of Plaintiffs to recover: (1) The compromise and settlement of claims in dispute does not give rise to taxable income. Mertens Law of Fed. Income Taxation, Vol. 2, §11.19 p. 71. (2) There is no income unless and until there has been a release of liability. Mertens Law of Fed. Income Taxation. Vol. 2, §11.19 p. 71. (3) When a

taxpayer is not enriched taxable income does not result. Mertens Law of Federal Income Taxation Vol. 2, §11.19. (4) An agreement to cancel a debt in the future is not income until the debt is actually cancelled. Mertens Law of Fed. Income Taxation, Vol. 2, §11.19 Footnote 15.

This Court is clearly of the opinion that the Plaintiffs did not in fact or constructively receive additional taxable income in 1961 as claimed by the Defendant and that the issue presented should be decided in favor of the Plaintiffs.

This the 16th day of May, 1967.

C. W. ALLGOOD
United States District Judge

A true copy, William E. Davis, Clerk United States Dstrict Court, Northern District of Alabama. By Mary L. Tortorici, Deputy Clerk.

SEAL

IN THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ALABAMA SOUTHERN DIVISION

ROBERT I. INGALLS, JR., and
MRS. JANE S. INGALLS,
Plaintiffs,
versus Civil Action No. 66-289

UNITED STATES OF AMERICA,
Defendant.

Filed in Clerk's Office, Northern District of Alabama May 16, 1967. William E. Davis, Clerk, U. S. District Court. By Mary L. Tortorici, Deputy Clerk.

JUDGMENT

In conformity with and pursuant to the memorandum opinion of the Court contemporaneously filed herein,

It is hereby ORDERED, ADJUDGED and DECREED that the Plaintiffs recover from the Defendant the sum of $180,959.35 together with interest thereon as provided by law.

It is further ORDERED that all costs be and they hereby are taxed against the Defendant, as allowed by law.

Done, this the 16th day of May, 1967.

C. W. ALLGOOD
United States District Judge

A true copy, William E. Davis, Clerk United States District Court, Northern District of Alabama. By Mary L. Tortorici, Deputy Clerk.

SEAL

APPENDIX B

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 25150

UNITED STATES OF AMERICA,
Appellant,

versus

ROBERT I. INGALLS, JR. and
MRS. JANE S. INGALLS,
Appellees.

Appeal from the United States District Court for the Northern District of Alabama

(August 9, 1968)

Before BROWN, Chief Judge and BELL, Circuit Judge and HOOPER, District Judge.

BELL, Circuit Judge: This appeal by the United States arises out of a suit by the appellee-taxpayer[1]

[1]Robert I. Ingalls, Jr. is referred to herein as "taxpayer". Mrs. Jane S. Ingalls is party to this action only by reason of her participation in a joint return with her husband.

for a refund of $180,959.85 in income taxes and interest paid for the year 1961. The District Court, after a non-jury trial, rendered judgment in favor of the taxpayer for the sums claimed. We reverse.

The question for decision is whether the compromise of taxpayer's employment contract claim against the Ingalls Iron Works Company is legally effective to spread the proceeds of the compromise over a ten year period for income tax purposes. The proceeds of the compromise were payable over a ten year period by way of an installment discharge by the company of taxpayer's indebtedness to the company. The District Court answered in the affirmative. We disagree.

The background of this case in one of intra-family and intra-corporate litigation extending over more than a decade. The particular question presented here concerns only a part of an over-all settlement agreement reached on January 30, 1961. The thrust of the settlement was to eliminate taxpayer from all involvement in the management and ownership of Ingalls Iron Works Company, a corporation owned by taxpayer, his mother, and trustees acting for taxpayer's two daughters.

In March 1959, taxpayer entered into a contract with Ingalls Iron Works to act as its General Manager for a period of fifteen years at an annual salary of $100,000. The validity of this contract was disputed by the remaining members of the Ingalls family. They claimed that the contract was invalid and voidable by the company.

Between 1953 and 1958, taxpayer borrowed funds from the company at various times for which he executed promissory notes. The exact amount of this indebtedness was likewise disputed, but on September 24, 1958, taxpayer's entire indebtedness to the company was reflected in his note for $258,664, bearing interest at two percent per annum and which was partially secured by twelve policies of insurance. Payments on the note between 1958 and January 30, 1961, had reduced taxpayer's indebtedness to $228,360, as shown on the books of the company.

In the late 1950's it became apparent that some settlement of the family feud would be in the best interests of the company. Negotiations over the settlement lasted for months and finally the agreement of January 30, 1961 was reached. The agreement as it related to taxpayer had three main points. By the first, which is not here in issue, he sold all of his stock in the company to W. H. Hulsey for $3.75 million and resigned as an officer, director and employee. By the second, also not in issue, "The Ingalls Litigation" (pending and threatened in the future) was finally ended. By the third, which gives rise to the issue here presented the dispute over the fifteen year employment contract was settled.

The contract settlement was contained in one document. Under its terms the company purchased the employment contract for $228,360 payable in equal installments of $22,836 on February 1st of the ten next succeeding years and, in turn, taxpayer agreed to pay off his outstanding indebtedness to the company

of $228,360 in equal installments of $22,836 on February 1st of the ten next succeeding years. The insurance policies which had served as collateral for the September 1958 note were released, the only security for the new note being taxpayer's promise to pay and the following provision: [Taxpayer] . . . further agrees that so long as any part of said indebtedness or any interest thereon remains unpaid, the company may make the payments hereinabove agreed to be paid to him by currently crediting said indebtedness with such payments as they accrue."

Thus on February 1st of any given year one of two things would occur. Either the taxpayer and the company would exchange checks for $22,836 or the company would simply make a bookkeeping entry whereby the $22,836 owed taxpayer by the company would be credited against the taxpayer's indebtedness to the company. The former course was followed each year, and the taxpayer would have the case turn on this "reality". It is undisputed that the taxpayer will be taxed on the $228,360 income. 26 USCA, § 61(a) (12).[2] The only dispute is whether the tax is to be paid in the year of the settlement agreement or over ten years as the checks are exchanged or bookkeeping entries made.

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[2] § 61. GROSS INCOME DEFINED.

(a) *General Definition.* — Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

* * * *

(12) Income from discharge of indebtedness;

In *Commissioner of Internal Revenue v. Court Holding Company,* 1945, 324 U.S. 331, 334, 65 S.Ct. 707, 89 L.Ed. 985, the Supreme Court said: "The incidence of taxation depends upon the substance of a transaction . . . . To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." This court has likewise repeatedly looked to the substance of transactions rather than to their form. See, for example, *Hindes v. United States,* 5 Cir., 1964, 326 F.2d 150; and *Reef Corporation v. Commissioner of Internal Revenue,* 5 Cir., 1966, 368 F.2d 125. The substance of the instant transaction is that by the agreement of January 30, 1961, a disputed contract claim was compromised for $228,360. The payment of the compromise was the discharge at that time of indebtedness due the company by the taxpayer in the same amount

The taxpayer argues and the District Court held that mutual debts do not cancel each other simply by operation of law, and, thus, there was no discharge on January 30, 1961. It is true that set-offs must be pleaded, but once pleaded, the set-off here would be allowed. See 3 Code of Alabama (Recompiled 1958) Title 7, § 350 and *Simmons v. Williams,* 27 Ala. 507, 511-512 (1855). Although the *Simmons* case involved independent debts which the court would not set-off, the court recognized that equity would set-off mutual debts where "one debt was contracted on the credit of the other," Such is the case here. Thus the formality of pleading the set-off would be the only barrier to

cancellation of mutual debts contracted on the credit of each other. The agreement here eliminates even the formality of having to plead the set-off since by contract the parties agree that if the taxpayer fails to pay the company, the company is authorized to effect a private set-off by making the bookkeeping entry mentioned above. The agreement speaks for itself and makes clear that the taxpayer had to perform no additional act for the debt to be discharged. A simple bookkeeping entry by the company each February 1st was all that was necessary. The exchange of checks by the company and the taxpayer was thus an empty ritual acted out for the benefit of the Commissioner and, in reality, the taxpayer was discharged from his indebtedness on January 30, 1961.

Taxpayer argues and the District Court held that there was a legitimate business purpose for the transaction here; therefore, the fact that there were tax motivations should not be a material factor in determining the tax consequences of the transaction. See *Gregory v. Helvering,* 1935, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935); and *Williams v. United States,* 5 Cir., 1955, 219 F.2d 523. There was a non-tax purpose on the part of the company in reaching the general settlement but the general settlement is not the relevant focus of inquiry. The relevant focus of inquiry is the installment aspect of the contract compromise. The fact of a non-tax business purpose for a general settlement cannot insulate the general settlement's component parts from examination to see if they were drawn solely on the basis of tax motivations. No non-tax business purpose is suggested by the taxpayer for

the installment aspect of the contract compromise. Indeed, the record is clear that the company would have preferred not to have used the installment arrangement.

It should be noted also, contrary to taxpayer's assertion, that it is the motive of the taxpayer that is important in the analysis of business purpose, not the motive of the company. There is no doctrine that a taxpayer is insulated from payment of income taxes because one party to an agreement may have a non-tax business purpose in yielding to tax-motivated demands on the part of some other party. Cf. *Northern Pacific Railway Company v. United States,* Ct.Cl., 1967, 378 F.2d 686, 692.

The instant situation is distinguishable from the case of *Estate of Lipman v. United States,* 6 Cir., 1967, 376 F.2d 455. There, although stock was purchased with proceeds partly payable in the form of debt cancellation, the taxpayer entered into a covenant not to compete over the period of the payments. The Sixth Circuit held that this covenant was a continuing obligation on the part of the taxpayer, which, if breached, would have defeated the taxpayer's claim for cancellation of the debt. No such continuing obligation on the part of the taxpayer existed here.

In our view, the most closely analogous case is *Williams v. United States,* supra. In that case, involving a sale of standing timber, the purchaser was ready and willing to pay the entire purchase price in cash. The vendor-taxpayer, however, set up a self-

imposed escrow arrangement which spread his receipt of the purchase price over several years. This was held to be a device to reduce the taxes due on the cash sale.

The taxpayer here set up the installment arrangement to reduce his taxes and for no other purpose. Hence, no sufficient business purpose appearing for the installment aspect of the contract compromise agreement, the substance of the transaction must be given effect. The substance of the transaction is that a disputed claim was settled, with payment being made by way of a discharge of indebtedness. The discharge was complete for income tax purposes in 1961. Thus the discharged indebtedness was income in 1961.

REVERSED and REMANDED for further proceedings not inconsistent herewith.

In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 849

ROBERT I. INGALLS, JR. AND MRS. JANE S. INGALLS, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW AND JURISDICTION

The opinions below and the basis for this Court's jurisdiction are adequately described in the petition.

QUESTION PRESENTED

Whether petitioner's [1] indebtedness of $228,360 to the Ingalls Iron Works Company was discharged in

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[1] "Petitioner" refers to Robert Ingalls, Jr. Jane Ingalls, his wife, is a party because a joint tax return was filed.

1961, so that the entire amount is includible in his gross income for that year?

STATUTE INVOLVED

Internal Revenue Code of 1954:

> SEC. 61. GROSS INCOME DEFINED.
>
> (a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:
>
> * * * *
>
> (12) Income from discharge of indebtedness;
>
> * * * *
>
> (26 U.S.C. 1964 ed., Sec. 61)

STATEMENT

The issue here arises out of the determination of the Commissioner of Internal Revenue that petitioner realized income in the amount of $228,360 in 1961 when the Ingalls Iron Works Company effectively cancelled petitioner's debt to the company in that amount in return for petitioner's renunciation of his rights under a long-term employment contract with the company.

Amounts petitioner borrowed from the company between 1953 and 1958 were reflected in a note executed on September 24, 1958, for $258,664. By January 1961, payments had reduced the principal amount of the note to $228,360. In March 1959, petitioner and the company had agreed that he would be

general manager for a period of 15 years at an annual salary of $100,000. An intra-family dispute extending over many years culminated in petitioner's elimination from all involvement with the company. During negotiations leading up to the final settlement on January 30, 1961, the company contended that petitioner owed the company more than the principal amount of the 1958 note and that the 1959 employment contract was invalid (Pet. 43-44.)

As part of the settlement, petitioner and the company agreed that he owed the company the principal amount outstanding on the note—i.e., $228,360—and that the company would pay him the same amount—i.e., $228,360—in return for a renunciation of his rights under the 1959 employment contract. This agreement was formalized in two contemporaneous documents, a termination agreement and a new note. In the former, the company agreed to pay petitioner $228,360 for his interest in the employment contract, in equal installments of $22,836, payable on February 1 of the ten next succeeding years. Petitioner in turn executed a new note for $228,360, payable in ten installments of $22,836, also on February 1 of the next ten years. In addition, the termination agreement provided that (Pet. 45) "so long as any part of said indebtedness [of petitioner] or any interest thereon remains unpaid, the company may make the payments hereinabove agreed to be paid to him by currently crediting said indebtedness with such payments as they accrue." The company accepted petitioner's new note, which was unsecured and bore no interest, in lieu of the 1958 note which was secured by insurance poli-

cies and bore annual interest of 2 percent. The insurance policies, which had been held by the company as collateral on the old note, were returned to petitioner (Pet. 44-45). Beginning on February 1, 1962, petitioner and the company exchanged checks for $22,836 and followed that course on each February 1 thereafter up to the date of trial (Pet. 44-45).

For each year up to trial, petitioner reported as income the $22,836 paid to him by the company on February 1 of that year. The Commissioner of Internal Revenue determined that the settlement of January 30, 1961 effected an immediate, full cancellation of petitioner's debt to the company in the amount of $228,360, resulting in gross income in that amount for 1961. (Pet. 33.) The district court agreed with petitioner that the amount could be reported as income in ten installments, consistently with the parties' exchange of checks each February 1. (Pet. 34-39.) The court of appeals reversed, holding that there was an immediate cancellation of petitioner's $228,360 debt as of January 30, 1961 (Pet. 46-49).

ARGUMENT

The decision below is correct. It is not in conflict with any other court of appeals decision and presents no issue which otherwise warrants review.

1. The court of appeals correctly held that the practical effect of the agreement entered into on January 30, 1961 by petitioner and the company was to absolve petitioner thereafter from making payments on his personal debt to the company. Thus the company's forgiveness of the debt, in return for petitioner' re-

nunciation of his employment contract, resulted in gross income to petitioner in the amount of the debt in 1961, the year in which the agreement was executed. Section 61(a)(12), Internal Revenue Code of 1954 (p. 2, *supra*). Petitioner and the company agreed that their mutual claims against one another were equal in amount and that one would offset the other. Solely to accommodate petitioner's desire to avoid taxation of the total amount of cancelled debt in one year, the company agreed, in effect, to record the cancellation on its books over a ten-year period and further agreed to exchange checks in identical amounts each year with petitioner.

Once the agreement was entered into, only one of two possible events would occur: either petitioner would give the company $22,836 each February 1 and the company would give it back to him, or he would not give the company $22,836 and the company would simply charge off the amount due on the note against petitioner's debt to the company. Neither event could have any economic or legal effect; after each February 1, each party would have exactly what it had before, and neither party at any time after the date of the agreement had a claim against the other which could be legitimately transferred or sued upon. (Pet. 46-47.)

As the court of appeals observed, once the agreement was entered into (Pet. 47), "the taxpayer had to perform no additional act for the debt to be discharged" so that (*id.*):

> The exchange of checks by the company and the taxpayer was thus an empty ritual acted out for

> the benefit of the Commissioner and, in reality, the taxpayer was discharged from his indebtedness on January 30, 1961.

Thus, under established tax principles set forth in Section 61(a)(12) of the Internal Revenue Code of 1954 (p. 2, *supra*), the full $228,360 was properly includible in petitioner's gross income for 1961.

2. The cases which petitioner claims to conflict with the result here involve the doctrine of "constructive receipt". (Pet. 13-27). That doctrine provides that when a taxpayer is absolutely entitled to receive funds which would constitute income if paid, inclusion of the funds in income cannot be avoided by the taxpayer's failure actually to claim the funds. Application of the doctrine typically turns on the degree to which the taxpayer was legally entitled to receive the funds in the taxable year in question. The cases cited in the petition were decided in favor of the taxpayers there involved because the particular circumstances of those cases imposed restrictions on the right to receive the funds in the years in issue. See *Richards' Estate* v. *Commissioner*, 150 F. 2d 837 (C.A. 2); *Commissioner* v. *Olmsted Incorporated Life Agency*, 304 F. 2d 16 (C.A. 8); *Kasper* v. *Banek*, 214 F. 2d 125 (C.A. 8); *Glenn* v. *Penn*, 250 F. 2d 507 (C.A. 6); *Willits* v. *Commissioner*, 50 T.C. 602. Where, however, the substance of a transaction as opposed to its form is that a taxpayer has the absolute right to receive funds, they will be taxed to him under the constructive receipt doctrine. See Regs. 1.451-2. See also *Newmark* v. *Commissioner*, 311 F. 2d 913 (C.A. 2); *Frank* v. *Commissioner*, 226 F. 2d 600 (C.A. 6); *Williams* v.

United States, 219 F. 2d 523 (C.A. 5). Thus, the cancellation of indebtedness here was properly deemed to have occurred for tax purposes when petitioner was assured that the debt no longer would have to be paid, just as in the constructive receipt area a taxpayer is deemed to have received amounts which he is assured of receiving upon his demand. There was no intent on the part of petitioner or the company that either would pay anything to the other in years after 1961 or that either would be placed at the risk of the other's nonpayment of its existing obligation after the termination of petitioner's relationship with the company. Simply put, the parties effected a "wash" of their claims against one another, effective as of January 30, 1961.

The conclusion reached by the court of appeals implements the following admonition of this Court in *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 334:

> The incidence of taxation depends upon the substance of a transaction. * * * To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

The substance of the transaction was an immediate cancellation of petitioner's debt to the company which was cast, exclusively for tax purposes, in the empty form of mutual installment payments of identical amounts on identical dates over a ten-year period. The court of appeals properly gave tax effect to the substance.

CONCLUSION

For the foregoing reasons the petition for a writ of certiorari should be denied.

Respectfully submitted.

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